

Submission to the Senate Select Committee on State Government Financial
Management.

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This submission describes the impact of recent developments in intergovernmental financial relations in Australia before assessing the sustainability and impact of existing State financial arrangements. It concludes with a discussion of options for reforming inter-governmental financial relations and Australian federalism more generally. It argues that while revitalising the Council of Australia Governments (COAG) and fostering a more cooperative brand of federalism may deliver some short term dividends, Australian federalism will remain prone to conflict and accountability problems as long as the States remain financially dependent on the Commonwealth. The submission assesses the financial position of the Australia States before examining reform options which would improve the vertical fiscal balance, the root cause of intergovernmental conflict in the Australian federation.

* The views expressed in this submission are those of the author and not those of the University of Tasmania.

Introduction

Few would dispute that a more cooperative, negotiated style of federalism has the potential to deliver significant dividends, but this submission argues that intergovernmental relations in Australia will remain prone to conflict as long as the States are financially dependent on the Commonwealth. Given this premise the paper examines the extent of the vertical fiscal imbalance in the Australian federation and whether the States have access to (and responsibilities for) sufficient revenues to deliver the services and infrastructure for which they are constitutionally responsible. Whilst the goal of improving the vertical fiscal balance in the Australian federation is laudable, it poses a range of related questions including: What functions should State governments perform in the Australian Federation? What level of funding is required to finance these tasks and should States be able to determine how such revenues are raised and if granted such fiscal autonomy how should State tax systems be structured? Having provided an overview of recent developments in intergovernmental financial relations, the submission evaluates some options for reforming fiscal federalism as well as assessing their political prospects.

The financial state of the States

Perhaps the most surprising aspect of the 1998 *A New Tax System (or ANTS)* package was the fact that the all of the GST revenue was to be allocated to the States in lieu of existing Revenue Replacement Grants (introduced after the 1997 *Ha Case*), general Financial Assistance Grants and a host of other indirect State taxes. Beyond securing State support the GST, the subsequent intergovernmental agreement (IGA) promised to put State finances on a more secure footing. This point made by the then Treasurer Peter Costello when he predicted that 'The GST will provide the States and Territories with a secure source of revenue that grows as the economy grows to secure funding for essential services, such as schools, hospitals and roads' (as Quoted in Hamill 2006, 126).

The key question is whether the IGA has in fact put State public finances on a more secure footing and whether the fiscal dividend from the GST is likely to adequately meet the future financing needs of State Governments?

Some observations in relation to the IGA:

- Delivered strong (not spectacular) revenue growth over the period 2000-07 of 8.9% (nominal) per year.
- But this growth has not been as strong as in other key Commonwealth taxes (CIT and even PIT), especially over the period 2004-2007. This highlights the fact that the Commonwealth controls all of the efficient growth taxes in the Australian federation.
- Most of the political debate has focused on the distribution of the GST revenue via the Grants Commission, especially surrounding the 2004 'Method Review' report and subsequent revisions to the distribution formula.
- Clearly the national tax system is more efficient as a result of eliminating the various taxes and duties specified in the IGA.

Some less obvious issues:

- The GST clearly remains a Commonwealth tax, collected by the Commonwealth under the auspices of Commonwealth legislation. Indeed it can be argued that Commonwealth actually used this control to appropriate a portion of the GST windfall by phasing out balancing payments to the two years ahead of schedule.
- The IGA has decreased the *fiscal capacity* of the States by further reducing the number of own-source taxes available to them. In 1999 40% of State revenue was from own-source taxes, by 2006 this figure is 33%. In Tasmania this figure is 20%.
- The IGA has increased the relative importance to the CGC process, hence the growing debate around the distribution formula and HFE process.
- The IGA has not reduced the level of Special Purpose Payments to the States and therefore has done little to address the VFI and associated accountability issues.

State Finances in the 21st century

Any analysis of the sustainability State public finances must consider three factors; projected levels of Commonwealth transfers, The State's own-source revenue base and likely expenditure pressures.

This submission has already argued that IGA has delivered significant revenue growth to the States which, when combined with very favourable economic conditions, has resulted in a significant improvement in State public finances. However, its much less clear whether the revenue delivered under the IGA will be sufficient to meet likely expenditure pressures confronting States governments, especially given the narrow and volatile nature of their remaining own-source taxes.

State Taxes in the 21st century

The most significant forms of State revenues are derived from taxes on payrolls (26%), property transactions (21%), land (7%) and gambling (10%). While this revenue base grew by 35% in nominal terms of the period 2000-07, this reasonable growth belies the volatile (in terms of yield) and inefficient nature of State taxation.

Column1	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	Increase \$	Increase %	Annual Increase %
Gambling Machine Tax	2,071	2,236	2,272	2,434	2,653	2,839	768	37.1%	7.4%
Payroll tax	9,503	9,671	10,162	10,839	11,996	13,087	3,584	37.7%	7.5%
Property tax	7,406	9,546	11,397	13,566	13,201	13,784	6,378	86.1%	17.2% (28%)
Total State Rev	32,679	33,341	36,418	40,394	41,649	44,235	11,556	35.3%	7.0%
Property tax contribution to growth		323%	60%	54%	0%	22%	55.1%w		

Table 1. Key trends in state taxation 2000-06. (Source: ABS 2007).

As outlined in Table 1, the majority of revenue growth (55%) over the period was derived from the \$6.37 billion per annum increase in property taxes over the period. The problem for State public finances is that this property tax windfall was the dividend of an unsustainable housing boom, a reality borne out by the fact that such revenues have declined in real terms since 2003-04 as realestate prices have stabilised and the volume of property transactions has fallen.

Narrowly based taxes are inevitably inefficient and volatile with periods of exceptional revenue growth, such as the States experienced during the early years of the decade, being punctuated with significant periods of stagnating or declining revenues. While State governments managed to achieve cash surpluses (and retire state debt) during the early years of the decade, in more recent times State Treasurers are once again trying to devise politically palatable ways of expanding their tax base as well as other sources of revenue.

Expenditure pressures:

While it is not possible to provide a comprehensive assessment of the expenditure pressures confronting the various State governments a brief examination of the recent data on the funding of public hospitals highlights the structural fiscal pressures the States confront.

The administration and funding of Australian healthcare is complex with the both Commonwealth and States making various (and notoriously variable) contributions. This hybrid funding model has attracted growing criticism on a number of fronts in recent years and the resulting governance problems have been well documented (AMA 2007, National Health and Hospitals Reform Commission 2008). While both levels of government fund Australia's public hospital system a significant trend in recent years, which has been identified by the Australian Insitutute for Health and Welfare, is that the States are assuming greater responsibility for funding Australia's public hospital system – and yet the States have the least capacity to pay.

This trend is particularly significant given that health care costs are growing faster than either GDP or tax revenue across the developed world. In the case of Australian public hospital system, total funding has increased at 12% per annum in nominal terms in the decade to 2005-06 (AIHW 2007). This is despite the fact that there has been increased utilisation of the private hospital system and despite growing recognition that even this level of funding is grossly inadequate (AMA 2007). In short, the States have been shouldering a greater share of the public hospital funding burden, a share which will have to increase significantly in order to improve the quality of key health services.

In absolute terms State governments have increased public hospital funding by between \$1 and \$1.6 billion per annum over the past three years (AIHW 2007, 55). Beyond this, State Governments have argued that they require an additional \$1.5 billion per annum to adequately fund the public hospital system (Queensland Government 2007). While this only represents one of the funding pressures confronting State governments, the growing revenue needs of public hospitals alone consumed 90% of the GST growth dividend in the most recent year for which data is

available.¹ Given the fact that the growth in Hospital funding is outstripping GST revenue growth by 3% per annum it seems inevitable that despite the IGA the public finances of State Governments are going to come under increasing pressure.

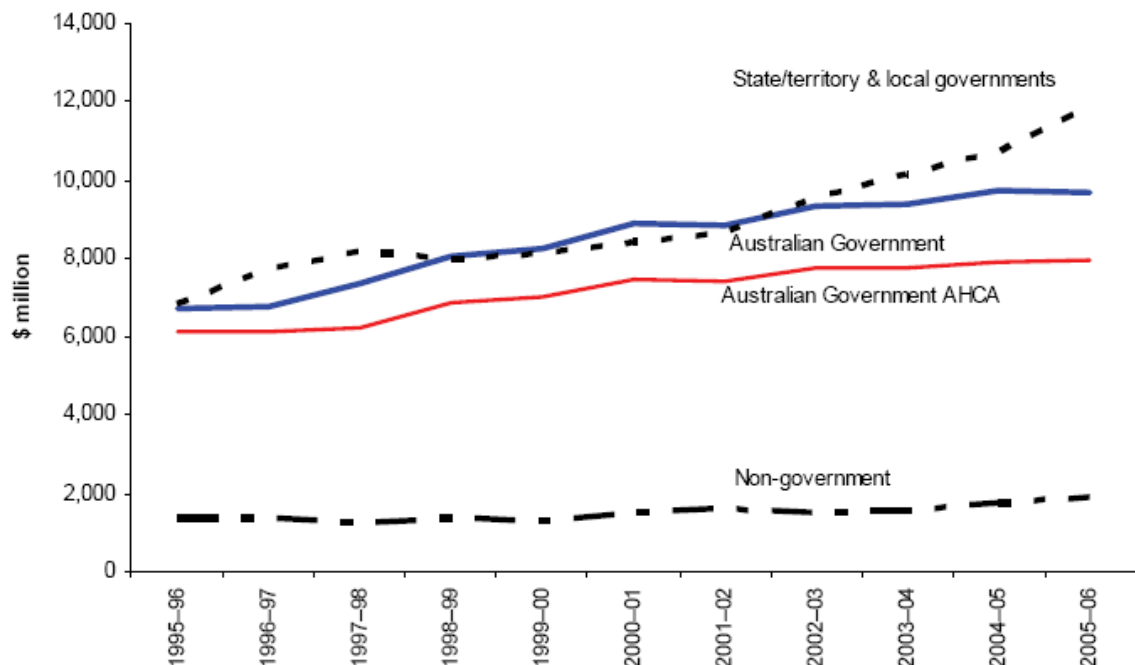


Figure 1. Funding sources for Australian Public Hospitals (Current Prices) 1995-96 to 2005-05. Source AIHW (2007, 55). Note: The upper line representing 'Australian Government' funding is inclusive of specific Australian Healthcare Agreement (AHCA) funding.

Reforming federalism: Issues and objectives

Political debates concerning the constitutional division of power in a federation will be familiar to Committee members as they are both fundamentally contested and age old. As a consequence it is important to preface any discussion of 'reforming' federalism with a clear overview of any implicit assumptions and values. The hope here is to avoid a flawed deductive logic in which conclusions naturally follow on from an arbitrary (or at least contestable) set of presumptions in relation to whether political power should be concentrated or dispersed in a federal system.

While there are empirical and normative arguments for and against fiscal decentralisation/centralisation, the reform options described below are largely informed by the view that in the interests of economic and administrative efficiency that key income and consumption taxes on mobile factors of production or assets should be administered by the national government. However this is not to say that States need to necessarily relinquish their capacity set their own tax rates and/or retain the capacity to make autonomous policy decisions. Indeed a number of compromises

¹ Between 2004-05 and 2005-06 GST revenue growth to the States was \$1.83 billion. Over the same period additional State funding to public hospitals was \$1.63 billion).

are possible which can enhance the efficiency of the national tax system while preserving key aspects of the federalism ideal.

A pragmatic compromise adopted in many federal states, such as Canada and Germany is for sub-national governments to share the most significant tax bases (such as personal income tax) with national governments. In practice this involves shared taxes being levied on a common base and administered by the national government, but with regional governments being able to determine the surcharge they require. Another compromise is to raise key taxes centrally and then redistribute revenue to the States so that retain control of spending decisions. A final option is for the Commonwealth, given its superior budgetary capacity, to fund the most expensive public services but to develop a governance model which promotes local management and control. In summary, the analysis which follows explores options which enhance the consistency and efficiency of the national tax system while reducing Australia's extreme VFI because on this issue there is a reasonably long standing consensus in the public finance literature that achieving a vertical fiscal balance is desirable because it avoids the uncertainty, dependency and accountability problems which result when one level of government in a federal system relies on transfers from another (Musgrave 1983).

On the issue of preserving the sovereign power of the State the analysis is more agnostic, but acknowledges that preserving the political power and independence of the States is desirable to the extent that it does not undermine the integrity of national tax system taken as a whole.

Options for Reform

Expanding the State revenue base

The IGA has left the States with a small and relatively fragmented tax base. Whereas in 1999-00 the States raised 40% of revenues with their own taxes, in recent years this has fallen to 30%. In the federation's poorest States (who benefit most from fiscal equalisation), such as Tasmania, only about 20% of expenditure is funded through own sources taxation. Given this narrow revenue base there is clearly limited scope to expand State taxation without incurring major economic, social or political costs.

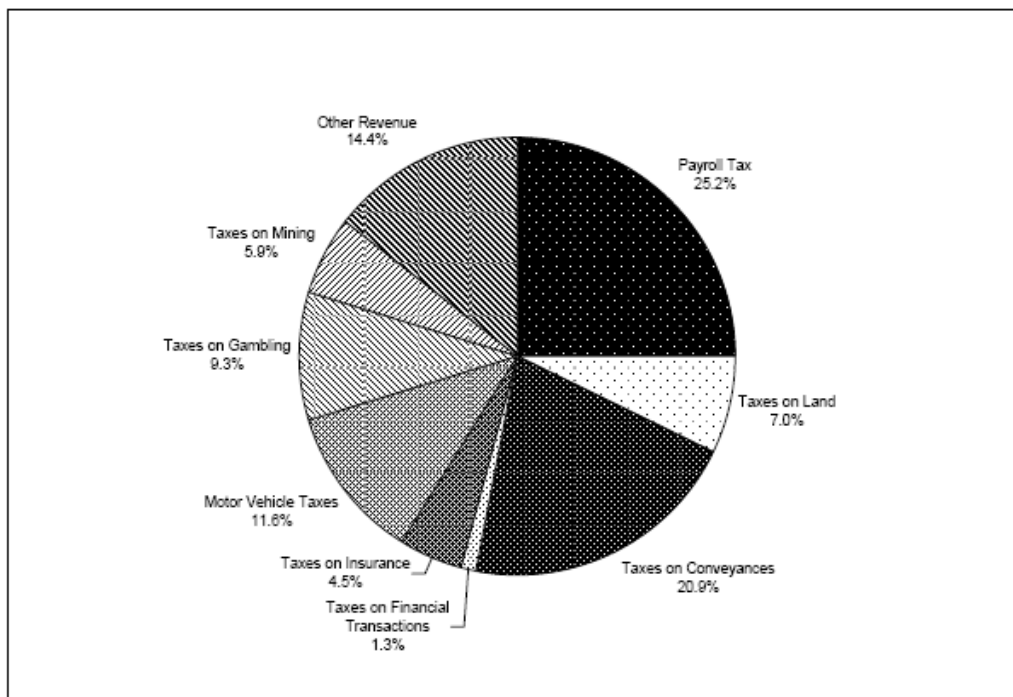


Fig 2. Structure of state taxation 2004-05. (Source: ABS 2007)

Figure 2 illustrates that the States are increasingly reliant on payroll, property and gambling taxes, yet there are real political and economic constraints on expanding any of these tax bases. We have already noted that the end of the property has reduced the prospects of achieving significant growth from this tax base, but the resulting political concerns about housing affordability mean that it will be very difficult for State governments to raise property taxes. Indeed a number of public and independent inquiries have highlighted (not to mention the federal government) the need to reduce State property taxes and charges in order to improve housing affordability (Productivity Commission 2004).

Form a public finance perspective payroll taxes represent the most efficient and reliable source of State revenue. and, as such, represent the best tax policy option if the State's were to expand their revenue base (Crowe 1999). The Australian reality however is not quite as appealing because all of the States impose their payroll taxes at different rates and on various tax bases. When combined with the fact that it is difficult to exempt exporters (as with a GST) payroll taxes can result in significant distortions and inefficiencies (see Warren 2004, 255). Even more compelling is that in his latest review of the impact of taxes on economic behaviour, eminent US tax scholar Joel Slemrod concluded that payroll taxes were one of the few taxes which had a detrimental effect on economic growth and welfare (Slemrod 2006). When combined with the fact that Australian business and employer groups have generally been successful in portraying State payroll taxes a taxes on jobs, its not surprising that there is little enthusiasm for exploiting this tax base more fully.

Finally State governments are becoming increasingly reluctant to increase their dependence on gaming revenue amid growing concerns about the social impact of gambling. It also appears likely that the 2007 federal election may represent the high watermark for gaming taxation in Australia. Federally recently elected Prime Minister

Kevin Rudd has also expressed a desire to 'help wean the states of poker machines', an agenda which will become a priority for the Labor Government if the high profile South Australian 'no-pokies' campaigner Nick Xenophon manages to influence the balance of power in the Senate. Given this context it seems inevitable that the federal government will try to limit the expansion of the gaming industry.

Increased Specific Purpose Payments to the States

The constitutional division of taxing powers in the Australian federation combined with the political and economic constraints describe above mean that it is extremely unlikely the Australian States will be able to expand their own-source tax base sufficiently to meet future expenditure needs. The most likely response to these funding pressures will be a steady increase in tied Commonwealth assistance to the States.

This approach is central to the Rudd Government's new federalism agenda which aims to create a culture of intense collaboration between the Commonwealth and State Labor governments (Kelly 2007).² While it appears that Rudd is genuinely committed to grant the States the independence to choose the means by which they achieve efficiencies and other policy goals, it seems quite clear that Commonwealth is less willing to negotiate when it comes to establishing the goals of intergovernmental reforms. For example, in terms of the *Hospital Reform Plan* it is quite clear that if the States fail to achieve agreed targets then the Commonwealth will give consideration to a federal takeover of public hospitals. While the Rudd Government may have the skill and commitment to negotiate significant intergovernmental reforms, history indicates that there are real limits to partisan loyalties and it is likely there will be serious political conflicts between State Labor Premiers and the federal Labor Government (Hamill 2006, 172-73).

Ultimately cooperative federalism can only work when the States and the Commonwealth have similar interests and when these interests differ the nature of the VFI in the Australian federation and the system of tied funding it which yields will inevitably result in cost shifting, accountability problems and intergovernmental conflict. Given these structural problems with Australian federalism more fundamental reforms may be necessary.

Radical reform options

The GST has provided solid revenue growth to the States since 2000, yet the analysis provided above indicates that the GST has failed to avert a deepening of the VFI afflicting the Australian federation in the face of the increasing expenditure pressures confronting State governments. If we accept that the VFI is the structural cause of much of the duplication, cost shifting and accountability problems which have plagued Australian federalism in recent decades then serious consideration needs to be given to reform proposals aim to address this imbalance. The following paragraphs will briefly sketch some proposals designed to realign taxing powers and spending responsibilities in the Australian federation.

² Prime Minister Rudd's first meeting with the Premiers in December 2007 established intergovernmental working groups for health, productivity, climate change and water, infrastructure, business competition, housing and indigenous affairs. (Metherell 2007).

Increasing the GST?

Perhaps the most logical and efficient proposal to reduce federal financial control over the States is to increase the existing GST to a level which would replace all existing Commonwealth Specific Purpose Payments (SPPs). Such a policy would potentially deliver a number of benefits. Firstly there are a number of international precedents for increasing the rate at which consumption taxes are levied in response to evolving fiscal, economic and political challenges (Eccleston 2007, ch2.). More importantly, such a reform would provide the states with the financial resources to provide public services for which they are constitutionally responsible without interference from the Commonwealth and in so doing would help restore political accountability within Australian federalism.

To what level would the GST have to be raised to fund the elimination of SPPs to the States? Based on table 2, which outlines the main sources of state revenue for 2005-06, an additional \$24.8 billion in GST revenue would be required to compensate the for SPPs foregone. Assuming that the increased GST is levied on the existing base and the increased rate has a negligible impact on consumption, a GST rate of the order of 16-18% would be required, a rate similar to that currently imposed in the United Kingdom (17.5%) and lower than that employed in most EU member states.

Composition of State Revenue 2005-2006	
Total State Revenue	\$142.0 billion
Own Source Tax Revenue	\$44.2 billion
GST Revenue	\$38.9 billion
Special Purpose Payments	\$24.8 billion
Other Revenue Source	\$34.1 billion

Table 2. Composition of State Revenue 2005-06. (Source: ABS 2007)

Clearly increasing the GST rate to eliminate SPPs to the States will have a number of political and economic consequences. Firstly it should be noted that increasing the GST will increase aggregate taxation in the absence of any offsetting tax cuts with the Commonwealth benefiting to the extent of the \$24.8 billion which would have otherwise been paid to the States. While some of this windfall would be used to provide compensation to adversely affected groups, such as those on fixed incomes, it would be possible to return a significant a significant proportion of this revenue to the two the States via the Commonwealth Grants Commission (CGC) in return for States eliminating some of the least efficient taxes along the lines of the original IGA. For example, based on 2005-06 figures the States could be allocated \$16 billion for agreeing to eliminate payroll taxes (\$13.1 billion) and gambling taxes (\$2.8 billion) still leaving \$8.4 billion for the Commonwealth to spend on appropriate compensation.

While such a reform proposal would improve economic efficiency as well as help restore accountability in Australia's federal system it clearly raises a number of political issues and may exacerbate some of the problems associated with the CGC

process. First and foremost any move to increase the GST rate will attract significant political resistance as consumers are confronted with higher prices and welfare groups and those on fixed incomes highlight the distributional impact of changing the tax mix in favour of consumption. Given the political passions which the tax has historically evoked in Australia it is likely that political resistance to any proposal to increase the GST rate would be even more intense. This is especially so given long held concerns that the Howard Government's 10% GST would be increased subsequent to its introduction, concerns that have given rise to periodic bipartisan commitments never to increase the GST.

The taboo nature of the GST was also highlighted during the 2007 federal election campaign when the then Treasurer Peter Costello attempted to convince voters that a federal Labor government would conspire with State Labor governments to increase the GST rate. In the heat of the election campaign this drew a quick commitment from Opposition Leader Kevin Rudd that 'under no circumstances will there be any increase to the GST, not over my dead body.' (Coorey 2007), a commitment which the Prime Minister reaffirmed after the 2020 Summit despite calling for a 'root and branch' review of the national tax system. So while there is both a clear case and a growing political movement to reform Australia's federal system, given the controversy and political baggage associated with the GST it seems unlikely that Rudd Government will give serious consideration to altering the GST rate.

Sharing other Commonwealth revenue bases

A less politically controversial alternative to increasing the GST would be to give the States access to a fixed percentage of existing Commonwealth taxes in lieu of existing SPPs. Such a proposal would give the States with greater financial independence and should not effect the net revenue positions of either State or Commonwealth Governments. Such a revenue sharing compromise is becoming increasingly common in federal systems given the growing consensus that major income taxes are best administered at a federal level (Norregaard 1997). For example, both Switzerland and Germany redistribute a fixed portion of their personal income taxes to sub-national government, while in Canada there have been recent moves to ensure that concurrent federal and provincial income taxes are levied on the same tax base in order to achieve administrative and compliance savings (Braun 2003).

Interestingly there are Australian precedents for this type of revenue sharing. As part of its 'new federalism' agenda in 1976 the Fraser Government's committed to provide 33.6% of Personal Income Tax revenue to the States as the basis for General Purpose Grants (GPGs) (Parliamentary Library 1976). This regime was finally abandoned in 1985-86 in part because of the Fraser then Hawke Government's concern that the formula was too generous.

This revenue sharing system may have been flawed in that it focused on the quantum of GPGs and because it could, unlike the IGA, be unilaterally amended by the Commonwealth, but it nonetheless has significant potential to improve both the financial security and political independence of the States. What is less well known is that the 1978 the Fraser Government went further and passed the *The Income Tax (Arrangements with the States) Act* which gave the States the authority to impose an

income tax surcharge on Commonwealth income tax should they require additional revenue. Alternatively State Governments could offer income tax rebates (Hamill 2006, 100). Predictably, in the absence of the Commonwealth creating sufficient 'tax room', no State governments took advantage of the legislation over the decade when it was on the statute books.

Despite this chequered history there is no reason why the issue of tax sharing could not be revisited as part of a review of fiscal federalism. For example, in 2005-06 the Commonwealth raised \$118.7 billion in personal income taxation (including FBT) so it would be relatively straight forward to replace existing SPPs to the States with a commitment to distribute 21% of personal income tax revenue to the States via the CGS. Despite the potential benefits the central argument against either increasing the GST or formulating a revenue sharing regime is that it would devolve more financial and political independence to the States in an era in which both sides of federal politics, policy experts and business groups are all calling for increased centralization and coordination of regulation and service delivery. Given this context a different solution to some of the challenges confronting Australian federalism is to address the VFI by increasing centralisation through the reallocation of responsibility for service provision to the Commonwealth.

Transferring Public Hospitals

We have already identified both the cost pressures and complex intergovernmental funding issues surrounding Australia's public health system. Given this situation it's not surprising that recent proposals to reform health services have focused clearly on health funding. Perhaps the most significant and interesting of these is the Rudd Government's *National Health and Hospitals Reform Plan*. While the plan aims to achieve a negotiated approach to improving the performance of Australia's public hospitals, with a \$2 billion Public Hospitals Reform Fund, the Federal Labor party has also expressed an intention to initiate a process whereby the Commonwealth would assume control of Australia's 750 public hospitals if the States had not implemented the Reform Plan and achieved some (as yet unspecified) progress towards achieving the Plan's goals.³ A central question is how much would such a transfer cost the Commonwealth and how would it impact on intergovernmental financial relations in Australia?

According to the most recent Australian Institute for Health and Welfare report into Health Expenditure (2007, 55) in 2005-06 total public spending on public hospitals was \$22.4 billion of which the Commonwealth contributed \$10.1 billion (under the National Healthcare Agreement and other SPPs) with the States contributing \$12.3 billion. If a Commonwealth takeover were to occur the federal government could justify reducing transfers to the States by the full \$22.4 billion because at present the Commonwealth's \$10.1 billion in National Healthcare Agreement Payments are classified as SPPs. Indeed if the Commonwealth were to assume responsibility for public hospitals then the States could almost afford to relinquish all of their SPPs which amounted to \$24.8 billion for 2005-06.

³ It must be noted that away from heat of the election campaign the federal Health Minister, Nicola Roxon has been talking down the likelihood of the Commonwealth assuming control of public Hospitals (Alexander 2008).

Table 3. Net financial implications of Public Hospital Transfers (based on 2005/06 AIHW Data)

<u>Commonwealth</u>	+ \$14.7 billion (Savings through cancellation of SPP to States) - \$12.3 billion (Assuming the State's share of PH funding)
<u>Net impact</u>	+ \$2.4 billion (in favour of the Commonwealth)

While there is clearly an initial shortfall \$2.4 billion for 2005-06 it is important to note that the cost of running public hospital is rising more rapidly than either revenue growth or other expenditure pressures, so it is likely that if a review of public hospital funding were to be considered in 2009 relinquishing SPP in return for the Commonwealth taking control of public Hospitals would be financially viable. Indeed in the longer term as hospital costs increase as a percentage of national economic output the States could be major financial beneficiaries of such a transfer (Productivity Commission 2005). So while centralised control of public hospitals would clearly offend the principle of subsidiarity and its normative commitment to decentralisation, in other important respects such a proposal has considerable merit. It would improve Australia's VFI and would eliminate the traditional cost and blame shifting between federal and States governments associated with Australia's public hospital system. Moreover, if the States agreed to relinquish SPP as part of the transfer then it would enhance their political and financial independence over those areas where they retained jurisdiction. Most significantly of all it seems that of all the reform proposal sketched above the transfer of responsibility for the management and funding of public hospitals to the States is the most politically feasible because given the political controversies and ever increasing cost associated with Australia's public hospital system the States may be willing to relinquish this responsibility.

Conclusion

This paper provided an aggregate assessment of State public finances in the context of recent political and economic developments. It concludes that while GST revenues to the States have increased at a rate of 8.9% per annum in nominal terms over the period, a combination of the parlous condition of the State's remaining own source taxes and the rapidly increasing expenditure pressures, mean that the States are under increasing financial pressure. Given this situation the second half of the submission briefly assessed some proposals to reform Australian fiscal federalism. The distributional nature of taxation is such that any proposal to reallocate taxing and spending powers is bound to encounter political resistance and for this reason it is unlikely that reforms designed to increase the GST or give the States access to percentage of Commonwealth revenues are unlikely gain significant political support. Yet on the other hand incremental reforms such as increasing existing State taxes or Commonwealth SPPs to the States will simply perpetuate many of the structural problems which presently afflict intergovernmental relations in Australia. Perhaps the most promising reform option assessed in this paper is the Rudd Government's proposal to assume financial responsibility for and management of Australia's 750 public hospitals. This proposal has three clear advantages. Firstly it would resolve the myriad of cost shifting and accountability problems which have afflicted federal-state relations in the area of health policy. Second it would help restore the fiscal balance in the Australian federation by assigning the area of fastest public expenditure growth to the level of government with the greatest fiscal capacity. Finally, at a political level, the health reform agenda seems to be gathering momentum and there is a growing

willingness to among State and Federal governments to consider radical reform proposals such as transferring responsibility for public hospitals to the Commonwealth.

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